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E.O. 12958: DECL: 04/10/2018

TAGS: [ECON](#) [PREL](#) [TU](#)

SUBJECT: ECONOMIC PARTNERSHIP COMMISSION SCENESETTER

Classified By: Ambassador Ross Wilson for reasons 1.4 B and D

11. (C) The EPC has added balance to a bilateral relationship that has been heavily weighted to political and security cooperation. At the start of last year's EPC meeting, Turkey's economy was in its sixth year of strong growth, the government was steering a steady course, and the business climate was vibrant, but bilateral relations and security cooperation were nearing a low point. This year, our bilateral relations and security cooperation are in much better shape, but the Turkish government has been weakened politically, while almost all of Turkey's economic indicators are turning negative. Our message to the Turks in this situation needs to be one of continuity. USG support for Turkey is one important constant in an uncertain world. Businesses and investors also reward continuity, and continuation of the strong economic policies of the past six years is the best way for Turkey to position itself to ride out the current global economic uncertainties -- and its domestic instability as well.

The Honeymoon is Over

12. (C) The first AKP government was singularly successful following an orthodox economic agenda with six "anchors": fiscal discipline and debt reduction; support for the Central Bank's anti-inflation program; following the IMF program; making progress on EU accession; structural reforms; and privatizations. These anchors -- and a favorable international financial environment -- contributed to the surge in foreign investment in Turkey since 2002.

13. (C) The second AKP government took office August 29 after a huge election win, taking 47% of the popular vote. In its first 100 days, it loosened several of these anchors. Investors and business groups were expecting the new AKP government to finally move forward on structural reforms, particularly Social Security, Labor Markets and Tax Administration reforms, but the government did almost nothing on the economic front. The GOT did finally submit the revised Social Security bill to the parliament, but it was immediately referred to a sub-committee and failed to advance. Instead, the government spent its election mandate pursuing domestic political goals: broad constitutional reforms that have yet to materialize, and achieving passage of only a vaguely worded constitutional amendment that might allow some girls with headscarves to attend universities, if the changes survive legal challenges.

14. (C) Turkey is paying a price for this exclusive focus on domestic politics. In the fourth quarter of 2007, businesses

began curtailing hiring and stopping capital investment due to a slowdown in domestic business activity. At the same time, the international financial environment began to turn negative for Turkey. Banks sharply curtailed lending and investors began re-assessing risk, particularly those in high current account deficit emerging markets like Turkey. Foreign investors began pulling capital out in January. The Istanbul Stock Exchange (ISE), on which 72% of shares are held by foreigners, fell 25% in the first quarter, and the Turkish lira fell nearly 10%. Slowing growth in export markets began to hurt Turkish companies at home. Turkish private companies have relied heavily on low-interest foreign borrowing (they had approximately USD 52 billion in foreign currency-denominated loans outstanding at the end of the year, much of it unhedged). As the credit crisis began to take hold, Turkish companies began having problems borrowing abroad or getting their existing loans refinanced at affordable rates.

¶5. (SBU) In February, in a rare show of unity, several Turkish business groups united in an appeal to the government to focus on the economy and move quickly forward on reforms that were of high interest to business. This seemed to have had an effect. GOT officials met with business leaders and announced some provisions of some reform bills, such as a 5% reduction in social security premiums in the draft Labor Markets Reform. The Social Security Reform was finally brought to the floor of the parliament for a vote. Then the tsunami hit.

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Wide-ranging Effects of the Party Closure Case

¶6. (C) The party closure case filed by Turkish prosecutors on March 14 against the ruling AK Party and 71 of its senior

members has had a negative effect politically and economically. The case is likely to drag on for months. There is no timeframe within which the Constitutional Court must make a decision.

¶7. (C) With the closure action hanging over it, the government finds itself seriously weakened. As a result, the government will be much less able to move forward on the economic reform agenda, even as it finally realizes how important those reforms are. It likely will be forced to make more political compromises than before, as it did recently when faced with union opposition to the Social Security Reform. It will be more cautious and move more slowly to avoid political problems, as it has been in recent weeks, delaying public release of its Labor Market Reform package while it informally consulted with unions about the bill's contents.

¶8. (C) This behavior is unlikely to win over foreign investors, who have grown increasingly negative about Turkish economic fundamentals. The pain thus far has mainly been felt by foreigners on the ISE, but the government also will pay a price later in the year, as bids for privatizations come in much lower than expected (e.g., the recent Ankara Gas Distribution sale, with an estimated USD 2-3 billion sales price that received only four bids, the highest being just USD 1.6 billion). Energy privatizations may be particularly hard hit by the closure case because the value of these investments is heavily dependent on investor confidence that the government will complete the energy market de-regulation process.

What This Means for the EPC

¶9. (C) Our message to the Turks should be one of continuity and support. The USG supports Turkey in its fight against terrorism, in its bid to join the European Union, and in its economic and political reform efforts. We understand that global financial conditions are not the most favorable right

now for high current account deficit countries like Turkey and the United States. Businesses and investors reward continuity. Turkey can best position itself to weather the current storm and benefit from the recovery by continuing with the policies and reform process that have been so successful the last six years. That will be more difficult now, but it also is the direction that the AKP now appears to want to go.

¶10. (C) This message of continuity is particularly important regarding our Caspian Energy Strategy. For over a decade, the U.S. and Turkey have worked together to open non-Russian routes to market for Caspian oil and gas. We have had some solid success. Oil is flowing through the Baku-Tblisi-Ceyhan pipeline, and gas now flows through the Turkey-Greece interconnector. But the priority now is natural gas, and gas pipelines are much more complex than oil to put together. At the same time, Turkey's role is changing, from one of transit state and EU accession candidate to that of a major energy consumer that has doubts whether the EU will ever accept it. We need to emphasize to Turkey that the best way to ensure their future energy supply and become an indispensable partner for its neighbors is to continue to help us realize the Caspian corridor. This means finding a practical solution that meets Turkey's energy needs and resolves gas transit issues. This will pay extra dividends when Iraqi gas is available to flow into and through Turkey.

¶11. (C) The EPC Business Event on April 16 will provide a good forum for emphasizing the continuity of USG support for Turkey and of Turkey's economic policies. It also is an opportunity to hear from businesses what holds them back from doing more business in Turkey. We are likely to hear many of the same complaints we have heard before, such as the lack of transparency and predictability in the legal system (such as the recent Constitutional Court decision blocking foreigners from buying real estate), lack of IPR protection, bureaucratic inefficiency, labor permits, and high employment taxes and severance pay. The good news is that GOT has several economic reform bills in draft that will address some of these issues. The EPC is an opportune time to remind the GOT what the business community's reform priorities are and encourage them to resolve these concerns in upcoming legislation where possible.

¶12. (C) The current economic difficulties also create opportunities. The largest US trade mission ever to Turkey, the Tradewinds Conference, will be taking place in Istanbul the same week as the EPC. The electricity sector, including a number of privatizations and the construction of Turkey's first civilian nuclear power plant, will open up many opportunities for US bidders and suppliers. Turkey remains one of the biggest U.S. agricultural export markets in the world. The Turks also are creating opportunities. For example, their new R&D law appears to allow foreign companies and universities to obtain GOT grants and tax exemptions for research work carried out in Turkey. But no one in the foreign business or university community seems to be aware of it yet. You may want to draw them out on these points, and then encourage them to publicize what should be an attractive offer, particularly for companies and universities that already have established Turkish connections or partners.

¶13. (C) The missing link in our relationship has been Turkish investment in the United States. Particularly now with EU accession a distant possibility, Turkish businesses are becoming more interested in doing business with, and investing in, the United States. As governments we can promote this by emphasizing our shared values and the continuity of our policy support, and then give businesses on both sides the chance to network and seek opportunities. The Commercial Service of USDOC recently initiated an "Invest in America" program to encourage inward FDI, and we need to make effective use of this as well.

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